Spring 2007

Moving Toward a Federal Law of Corporate Governance in Bankruptcy

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MOVING TOWARD A FEDERAL LAW OF CORPORATE GOVERNANCE IN BANKRUPTCY

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I. INTRODUCTION

State law control over the corporate governance of publicly held corporations is dying a slow death in bankruptcy at the hands of an overzealous Congress. Recent amendments to the Bankruptcy Code (the "Code") push the state fiduciary law that governs the behavior of corporate directors and officers closer to irrelevance by making federal securities laws the strongly preferred means to find and hold accountable rogue managers of bankrupt corporations. This change in the corporate law began outside of bankruptcy. In the wake of the corporate scandals that erupted in the early 2000's, Congress adopted the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"),[1] which includes the most extensive and detailed corporate governance provisions enacted by Congress to date.[2] In doing so, Congress acted on the belief that state law had failed to deter, prevent, and provide accountability for such business disasters and sought to provide federal legislation to insure that the Enron catastrophe, and those like it, would never occur again.[3] By amending the Code with the same policy goals in mind, Congress not only adopted legislation that governs, more carefully than ever, the internal affairs of a corporation, but has paved the way for those regulations to remain forceful and relevant even after a bankruptcy case has been filed. The latest additions did not similarly provide for the effective application of state law corporate governance mechanisms.

The amendments to the Code do not make state law corporate governance mechanisms more difficult to enforce either. Rather, they completely clear the way for the enforcement of federal securities laws without accommodating already difficult to enforce state fiduciary duty obligations. The likely result

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1. 15 U.S.C.A. §§ 7201 et seq. (West 2004).
2. Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Just Might Work)*, 35 CONN. L. REV. 915, 917, 954–55 (2003).
3. Lyman P.Q. Johnson & Mark A. Sides, *Corporate Governance and the Sarbanes-Oxley Act: The Sarbanes-Oxley Act and Fiduciary Duties*, 30 WM. MITCHELL L. REV. 1149, 1202–1205 (2004) (describing how Delaware judges are sending signals to Congress that they are aware of the problems with corporate monitoring that led to Enron, and they do not intend to allow such behavior to pass as "good faith" management in Delaware).

of the latest changes is that state corporate governance standards will be ignored in favor of securities enforcement litigation after a corporation has entered bankruptcy. The fact that the two regimes have different purposes and cover somewhat different kinds of behavior will be lost in attempts by plaintiffs' attorneys to find and pursue the course of litigation that is most likely to succeed. This may result in investor plaintiffs recasting traditional state law claims alleging breaches of fiduciary duty as private enforcement actions against a debtor's officers and directors.[4] Courts have tried to prevent litigants from using that approach,[5] but with state corporate governance litigation virtually non-existent in bankruptcy and securities actions fully preserved, the trend may continue and magnify.

This essay begins by considering the most recent changes to the federal law regarding securities regulations. It covers Sarbanes-Oxley as well as the resulting contributions of relevant self-regulatory organizations ("SROs"). Part II considers the three most recent changes to the Code regarding corporate governance and analyzes how those amendments affect the treatment of a corporate debtor's officers and directors in the event of severe mismanagement. Part III will turn to the national trend toward federal securities law regulation of corporate governance itself and determine how that trend may impact bankruptcy law. The essay concludes that Congress has thoroughly provided for federal securities law regulation of officers and directors of a bankrupt corporation but has ignored important state law policies along the way without providing clear means to close the gap. Bankruptcy courts must use the few tools the Code provides and the discretion they are afforded to approach problems with a debtor's management in a way that observes state law corporate governance standards. It is through this exercise of discretion that state common law achievements in the area of corporate governance will not be lost upon the filing of a bankruptcy case.

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4. Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections Upon Federalism*, 56 VAND. L. REV. 859, 903–07 (2003).

5. *See* Santa Fe Industries v. Green, 430 U.S. 462 (1977); Gelles v. TDA Indus., Inc., 44 F.3d 102 (2d Cir. 1994); GBJ Corp. v. Sequa Corp., 804 F. Supp. 564 (S.D.N.Y. 1992); United Canso Oil & Gas Ltd. v. Catawba Corp., 566 F. Supp. 232 (D. Conn. 1983).

II. RECENT CHANGES TO THE LAW OF CORPORATE GOVERNANCE

The internal affairs of corporations, particularly those relating to corporate management, have long been the province of state law.[6] Through the development of their common law, states have achieved a careful balance between allowing directors and officers to exercise independent business judgment and imposing consequences for disloyal or grossly negligent management.[7] The state law of corporate governance provides for director and officer accountability to the corporation and its shareholders through shareholder election of directors and the enforcement of fiduciary duties owed by managers to the corporation.[8] The standards for management behavior set by the fiduciary duties of loyalty, care, and good faith are purposely less precisely defined than the rules contained in the federal securities laws.[9] Because they are creatures of equity, fiduciary duties are defined in broad terms that are open to varying interpretations given the circumstances of a specific situation.[10] Chief Justice Veasey states that "[t]he standard of conduct of directors is that they shall act loyally, with due care, in good faith, and in the honest belief that they are acting in the best interests of the corporation."[11] The duty of care requires that corporate managers inform themselves of "all material information reasonably available" when making decisions on behalf of the corporation.[12] State law has found significant benefits to shareholders in encouraging managers to exercise independent business judgment and take risks without fear of incurring personal liability.[13] Over the years, Delaware courts have remained aware of the fact that imposing frequent personal liability on corporate officers and directors would have negative consequences for the shareholders that very liability seeks to protect.[14] If the law were to hold directors and officers personally responsible too often or simply for unsuccessful but good faith business decisions, then those managers would not

6. E. Norman Veasey, *State-Federal Tension in Corporate Governance and the Professional Responsibilities of Advisors*, 28 J. CORP. L. 441, 443 (2003).
7. William T. Quillen, *The Federal-State Corporate Law Relationship–A Response to Professor Seligman's Call for Federal Preemption of State Corporate Fiduciary Law*, 59 BROOK. L. REV. 107, 128 (1993).
8. STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 193 (2002).
9. Johnson & Sides, *supra* note 3, at 1194.
10. *Id.*
11. Veasey, *supra* note 6, at 445.
12. *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 749 (Del. Ch. 2005).
13. Quillen, *supra* note 7, at 119–20.
14. *Id.*

be willing to allow the corporation to take profitable business risks and many talented managers may refuse to serve at the helm of a corporation in the first place.[15] Courts preserve these benefits by making judgments about director obligations and standards of behavior without applying strict, detailed rules of conduct.[16] By applying the relevant fiduciary duty standards, a judge may decide if the directors or officers of a corporation have behaved in a manner the law should deter and punish. Fiduciary standards allow courts to impose personal liability on officers and directors sparingly and only in the face of the most egregious instances of disloyalty.

In contrast to state law's system of loose standards that are open to judicial interpretation, federal law has adopted more particular regulations accompanied by a range of proportionate sanctions that can be more easily and predictably applied to situations of director or officer misconduct.[17] Because federal law regulates corporations through securities laws, federal regulations relating to corporate governance almost exclusively apply to publicly traded corporations[18] and tend to focus on disclosure.[19] With Sarbanes-Oxley, Congress enacted provisions that use accounting and disclosure requirements to reach into the realm of corporate governance.[20] Some of the new provisions, particularly as they were made effective through SEC and, in turn, SRO regulations, give more precise definition to the duties of loyalty and care that are creatures of state law.[21] For example, section 302 of Sarbanes-Oxley requires subject companies to file periodic financial reports that the relevant "principal executive officer" and "principal financial officer" must certify.[22] If the company must later restate its accounting disclosure due to material noncompliance, the chief executive and financial officers must reimburse the company for bonuses they received in the year following the incorrect disclosure and any profits they realized from trading in their company's securities during that time.[23] This disgorgement serves as a direct sanction against chief corporate officers for failing to uphold the requisite standard of

15. *Id.* at 118–19.
16. *Id.* at 128.
17. Johnson & Sides, *supra* note 3, at 1195–96.
18. Section 10(b) of the Securities and Exchange Act and the accompanying SEC Rule 10b–5 are notable exceptions to this. Rule 10(b) outlaws the fraud relating to the purchase or sale of "any security" whether or not it is listed on a national exchange. 15 U.S.C.A. § 78j(b) (2006).
19. Thompson & Sale, *supra* note 4, at 910.
20. *Id.*
21. *Id.* at 886, 903–04.
22. Sarbanes-Oxley Act § 302, 15 U.S.C.A. § 7241(a) (West 2004).
23. Sarbanes-Oxley Act § 304, 15 U.S.C.A. § 7243(a) (West 2004).

care in discharging their duties.[24] Subject companies must also adopt and disclose a code of ethics regulating the behavior of senior financial officers and further publicize the company's internal control structure or explain why they have not done so.[25]

At the behest of the SEC, the SROs[26] have adopted regulations detailing the management structure and procedures required of listed companies. These regulations speak directly to the form and function of a corporation's management. For example, NYSE, NASDAQ, and AMEX have all enacted regulations requiring listed companies to maintain a board consisting of a majority of independent directors and to form a board nominating committee responsible for determining the qualifications required of directors of the company and nominating members to serve on the board.[27] The SRO regulations take the code of ethics requirements of Sarbanes-Oxley a step further and provide that listed companies implement and publicly disclose a code of ethics which must, at minimum, address conflicts of interest, corporate opportunities, confidentiality, fair dealing, the protection and proper use of the company's assets, and compliance with laws, rules, and regulations.[28] A listed company's code of ethics must also include compliance provisions and detail what action will be taken in response to violations.[29] These regulations force corporate managers to confront and publicly disclose exactly how they will

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24. Thompson & Sale, *supra* note 4, at 904–08. In most cases, directors are no longer subject to personal liability for breaches of the duty of care. Officers may not escape that personal liability, but state law focuses on director control over corporations, and the law surrounding officer liability has not been developed thoroughly in the Delaware statutory or common law.

25. Sarbanes-Oxley Act §§ 404, 406, 15 U.S.C.A. §§ 7262, 7264 (West 2004). Here again, Congress is specifically defining and regulating the duty of care by telling officers exactly what steps they have to take to fulfill their obligation of due care.

26. A "securities self regulatory organization" is defined in section 101(48A) of the Code as "either a securities association registered with the Securities and Exchange Commission under section 15A of the Securities Exchange Act of 1934 or a national securities exchange registered with the Securities and Exchange Commission under section 6 of the Securities Exchange Act of 1934" and includes the New York Stock Exchange (NYSE), the National Association of Securities Dealers (NASDAQ), and the American Stock Exchange (AMEX). 11 U.S.C.A. § 101(48A) (West Supp. 2006); Levin & Ranney-Marinelli, *infra* note 38, at 634.

27. *See, e.g.*, New York Stock Exchange, Listed Company Manual, NYSE §§ 303A.09, 303A.10, *available at* http://www.nyse.com/RegulationFrameset.html?nyseref=&displayPage=/about/listed/1022221393251.html (last visited Apr. 1, 2007); American Stock Exchange, Company Guide, AMEX §§ 802, 803, *available at* http://wallstreet.cch.com/AMEX/CompanyGuide (last visited Apr. 1, 2007). These two particular regulations do not apply to companies in bankruptcy. NYSE § 303A.00, AMEX § 801 (b). *See also* NASDAQ Corporate Governance: Summary of Rules Changes (Nov. 2003) *available at* http://www.nasdaq.com/about/CorpGovSummary.pdf (last visited Apr. 1, 2007).

28. NYSE § 303A.10. Violations of these elements of a code of ethics would constitute breaches of fiduciary duty under state law.

29. *Id.*

order the company and the performance of their responsibilities so as to avoid breaches of fiduciary duty and violations of securities laws. Here, federal securities law, through the use of SROs, has asked corporate managers to specifically define some breaches of fiduciary duty, methods to avoid those breaches, and penalties to accompany their breaches. This offers a far more specific form of internal monitoring than Delaware law has ever required.[30]

Sarbanes-Oxley and the accompanying SEC and SRO regulations do more than attempt to specifically define points of fiduciary law. They use the tool of increased disclosure obligations to make publicly traded corporations even more transparent to all investors.[31] Consequently, those trying to enforce the securities laws may address a wide array of dishonest, careless, or faithless management behavior that is usually monitored by state law.[32] Shareholders can now, through Sarbanes-Oxley, hold officers directly liable for failing to uphold particular managerial obligations.[33] Given the enhanced internal monitoring and public disclosure requirements, ignorance is no longer a defense for CEOs and CFOs and deception has been all but eliminated as a reason for investor loss.[34] Federal securities laws have aimed to move corporate government out from behind the proverbial curtain. As a consequence of the fact that shareholders can recover more directly through securities causes of action[35] and plaintiff's lawyers can exercise more control over the litigation than under state law,[36] federal causes of action have become the preferred method of recovery when faced with severe mismanagement.[37] The trend toward the dominance of federal law when faced with wrongdoing by corporate managers has extended to bankruptcy, particularly in light of the most recent additions to the Code. Bankruptcy law has evolved in the past few years to allow federal securities regulations to be more fully, if not completely, enforced within both individual and corporate bankruptcy cases.

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30. Johnson & Sides, *supra* note 3, at 1211–13.
31. Cunningham, *supra* note 2, at 962–65.
32. *Id.* at 957–58.
33. Thompson & Sale, *supra* note 4, at 903–06.
34. Cunningham, *supra* note 2, at 956.
35. In class actions brought under the federal securities laws, investor plaintiffs recover directly from the wrongdoers. Derivative litigation under state law results in a recovery for the corporation. BAINBRIDGE, *supra* note 8.
36. The requirement that shareholders wishing to sue corporate managers for breach of fiduciary duty first demand that the board of directors pursue the suit on the corporation's behalf and the fact that the corporations own the derivative actions slow derivative suits and threaten to remove them from the shareholder plaintiff's control.
37. Thompson & Sale, *supra* note 4, at 860.

III. AMENDMENTS TO THE CODE

Three new Code sections in particular impact the regulation of the behavior of directors and officers of public corporations that have filed bankruptcy. Sections 362(b)(25) and 1104(e) were enacted as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA")[38] and section 523(a)(19) was added to the Code by Sarbanes-Oxley in 2002.[39] Together, these provisions clear the way for the enforcement of securities regulations in bankruptcy, though do nothing to make state law corporate governance mechanisms easier to administer within a bankruptcy case. This show of favoritism toward federal regulations over state governance mechanisms represents a clear choice by Congress to use the structures provided by federal law to monitor and regulate the behavior of corporate managers before a bankruptcy court. That means that federal rules and regulations will most likely and most effectively determine which of a corporate manager's past or present misdeeds she remains accountable for after she or the corporation she works for files for bankruptcy.

A. SRO Actions Excepted from Automatic Stay

First, section 362(b)(25) excepts from the automatic stay investigations or actions by SROs, to enforce their regulatory power through necessary investigations and the imposition of non-monetary sanctions.[40] While courts have long recognized that SEC enforcement actions are not barred by the automatic stay under section 362(b)(4),[41] actions brought by SROs to enforce securities regulations could not proceed.[42] Before BAPCPA, SROs moved for

38. Richard Levin & Alesia Ranney-Marinelli, *The Creeping Repeal of Chapter 11: The Significant Business Provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, 79 AM. BANKR. L. J. 603, n.137 (2005).

39. Keith N. Sambur, *The Sarbanes-Oxley Act's Effect on Section 523 of the Bankruptcy Code: Are All Securities Laws Debts Really Nondischargeable?*, 11 AM. BANKR. INST. L. REV. 561, n.236 (2003).

40. 11 U.S.C.A. § 362(b)(25) (West Supp. 2006).

41. Section 362(b)(4) excepts from the automatic stay actions brought by governmental units to enforce their police and regulatory power and judgments, other than money judgments, obtained in such an enforcement proceeding. 11 U.S.C. § 362(b)(4) (2000).

42. *See In re* Drexel Burnham Lambert Group, Inc., Bankr. No. 90B-10421 Dec. 14, 1990, 1990 WL 302177 at *6 (Bankr. S.D.N.Y.) (denying NYSE's motion for modification of the automatic stay to allow it to proceed with disciplinary proceedings against the debtor corporation because, among other reasons, NYSE is not a governmental unit and cannot avail itself of § 362(b)(4) and the court could not find cause to modify the stay on account of its role in the SEC's enforcement efforts); *In re* Colin, Hochstin Co., 41 B.R. 322 (Bankr. S.D.N.Y. 1984) (modifying the stay to allow NYSE to proceed with an investigation, but denying NYSE exemption from the automatic stay as a governmental unit

modification of the automatic stay in order to proceed against a debtor. Courts often denied the motion because the SRO's investigation or enforcement action was considered duplicative of pending SEC enforcement actions or because such litigation would do more harm to the estate than good for the investing public.[43]

Nevertheless, the SEC has traditionally given SROs significant power to regulate the public securities markets, and the SROs' role increased dramatically with the adoption of Sarbanes-Oxley, which extended their authority far beyond the broker-dealer context.[44] The rules SROs have promulgated in the wake of Sarbanes-Oxley reach further into the details of the corporate management of listed companies than federal rules have in the past.[45] SROs may impose any number of non-monetary sanctions against listed bankrupt companies including censure, public reprimand, or the delisting of the debtor's stock. Sanctions involving listed companies seem to be strictly limited to punishment for the company itself as opposed to individual directors and officers and reprimand is the most common sanction imposed.[46] Typically, the practice of holding a corporation responsible for violation of securities laws is merely a starting point for or part of a larger goal of holding those personally responsible for the corporation's activities accountable.[47] SRO regulation of listed companies seems to eschew that practice and simply punish the company itself.[48]

That distinction may render section 362(b)(25) either meaningless or harmful, depending on the circumstances. Because a corporation can only act through its human agents, punishing a debtor corporation for the failings of its corporate governance structure and internal controls without punishing the miscreant managers responsible for harming it seems hollow. Largely through

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under § 362(b)(4)).

43. *See, e.g.*, *In re* Drexel Burnham Lambert Group, Inc., 1990 WL 302177.

44. Johnson & Sides, *supra* note 3, at 1156–60.

45. *See supra* text accompanying notes 14–35.

46. NYSE § 303A.13. SROs may exercise even more control over member broker-dealer companies by directly disciplining those affiliated with member companies through expulsion, suspension for any period of time, limitation of activities, or censure. These sanctions may be imposed when a member company or an employee of a member violates federal securities laws, violates agreements with the SRO, violates SRO rules, makes material misstatements to the SRO, commits fraud or makes a misstatement or omits a material fact in any SRO submission. NYSE Rule 476, Disciplinary Proceedings Involving Charges Against Members, Member Organizations, Allied Members, Approved Members, Employees, or Others, *available at* http://rules.nyse.com/NYSE/NYSE_Rules (last visited Apr. 1 2007)..

47. Memorandum from Paul J. McNulty, Deputy Attorney General to Heads of Department Components, United States Attorneys 2 (2006) (on file with author).

48. SROs may delist other securities outside of bankruptcy, but only stock can be delisted despite the automatic stay. 11 U.S.C.A. § 362(b)(25) (West Supp. 2006).

the imposition of the automatic stay, bankruptcy law protects a debtor corporation from intrusion while allowing it to recover from those responsible for injuring it or improperly diminishing its assets. As it applies to the newer SRO regulations, section 362(b)(25) does exactly the opposite. Granted, corrupt corporate managers can be reached in other ways, either through direct securities law enforcement actions against them or through the pursuit of derivative actions under state law for breach of fiduciary duty. The availability of other means to respond to director and officer misconduct seems to offer even more support for the proposition that SRO enforcement actions do not add very much to the corporate governance jurisprudence in bankruptcy. SRO enforcement actions resulting in the penalization of a corporate debtor may not offer the protection to investors and creditors that is not already provided by SEC or private enforcement actions.

Traditionally, SROs have focused on the regulation of broker-dealers and their employees.[49] Perhaps section 362(b)(25) was intended to address the narrow set of cases in which broker-dealers or their employees have filed bankruptcy. In those cases, section 362(b)(25) can be a significant piece of the regulatory puzzle. Still, it is not clear that courts were reaching the wrong results in their analysis of the problem before the amendment. There, duplicative SRO enforcement actions were not permitted to proceed while those that were important to government policies of regulating broker-dealers were allowed to go forward via modification of the automatic stay.[50] While SROs do play an important role in SEC regulation of the public securities markets, it is not clear why duplicative enforcement efforts against a debtor in bankruptcy serve important policy goals. Any additional benefit gained through the duplicative actions may not exceed the cost that the investigation and resulting penalties impose on a debtor, and thereby, its creditors.

Ultimately, it may be that the real significance of this provision is not in the increased sanctions and investigations bankrupt corporations remain vulnerable to even after they have filed. Rather, the importance of the addition of section 362(b)(25) is that it constitutes one more way in which bankruptcy law is preserving and enhancing the growth of federal securities laws into the domain of internal corporate affairs by creating one more federal securities regulatory body that debtor corporations must answer even after the filing of a bankruptcy petition. By clearing the way for every form of securities law enforcement to continue to investigate and sanction violations after the subject

49. Jarad D. Hunter, Comment, *"No Crying in Baseball" and No More Crying on the Stock Markets: An Alternate-Hybrid Approach to Self-Regulation*, 74 U. CIN. L. REV. 639, 647 (2005).

50. *In re* Drexel Burnham Lambert Group, Inc., 1990 WL 302177 at *6 (Bankr. S.D.N.Y. Dec. 14, 1990); *In re* Colin, Hochstin Co., 41 B.R. 322 (Bankr. S.D.N.Y. 1984).

corporation has filed bankruptcy, Congress has confirmed that federal law will take the lead in regulating corporate wrongdoing. No similar provisions were added to the Code in order to ease, or even permit, the continuation of state law derivative actions after a bankruptcy petition has been filed.

B. Exception from Discharge

In 2002, the Sarbanes-Oxley Act added section 523(a)(19) to the Code. This provision goes one step further toward protecting SEC actions in bankruptcy to the exclusion of fiduciary duty suits by stating that an individual debtor may not discharge obligations incurred for the violation of any state or federal securities laws or any regulation or order issued under such securities laws.[51] The congressional purpose for enacting this change in the Code was "to prevent wrongdoers from using the bankruptcy laws as a shield and to allow defrauded investors to recover as much as possible"[52] by holding "accountable those who violate securities laws after a government unit or private suit results in a judgment or settlement against the wrongdoer."[53] While this section makes an allowance for state laws, it focuses again on securities regulations and does not preserve for corporate or derivative shareholder plaintiffs the fruits of a cause of action brought for breach of fiduciary duty. This exception from discharge includes obligations resulting before, on, or after the petition date and is applied retroactively to bankruptcy cases that were filed before, but still pending after, its adoption.[54]

It applies most often to circumstances in which individual brokers settle or lose suits against them for securities fraud and then file bankruptcy when faced with the magnitude of the resulting obligation.[55] By enacting this provision, Congress may have been trying to address the hypothetical situation in which a corporate executive responsible for an enormous public securities scandal seeks refuge in bankruptcy. That circumstance is hardly likely or common, however. In the simpler set of cases involving individual small-time brokers, one loophole in the exception might be significant. While the exception to discharge applies in both individual chapter 7 and chapter 11 cases, amounts owed on account of securities law violations can be discharged

51. 11 U.S.C. § 523(a)(19)(A)(I) (2000).

52. *In re* Gibbons, 289 B.R. 588, 593 (Bankr. S.D.N.Y. Mar. 7, 2003) (quoting 148 CONG. REC. S7418 (daily ed. July 26, 2002, statement of Senator Leahy)).

53. *Id.* at 593 (quoting S. REP. No. 107–46 at 2 (2002)).

54. *Id.* at 594–95.

55. *See, e.g., id.*; *In re* Chan, 355 B.R. 494 (Bankr. E.D. Pa. Oct. 23, 2006).

following the successful completion of a chapter 13 plan.[56] The brokers most often caught in the trap of § 519(a)(19) are likely to be pushed into filing bankruptcy under chapter 13 instead of chapter 7 by the means test added by BAPCPA.[57] This might create a way around a new subsection that was intended to close a perceived loophole in the first place.[58] These facts might mean that section 523(a)(19) is not the widespread reform it was intended to be, but that does not mean its stated goals are not admirable.

The amendment may fall short of the policy goals motivating its promulgation because it is expressly limited to violations of securities laws. Securities laws do not respond to common problems with corporate governance that do not involve the purchase or sale of securities, such as self-dealing by an officer or director or bad faith in the management of the corporation. Further, Sarbanes-Oxley and its related rules and regulations do not reach privately held companies which constitute over 98% of chapter 11 cases.[59] The confines of securities laws similarly limit the effectiveness of this exception to discharge. With personal liability for breach of fiduciary duty being imposed as sparingly and judiciously as it is, one wonders why bankruptcy law would want rogue corporate managers to escape state law accountability for disloyalty or gross mismanagement. Congress certainly knows how to prevent debtors from discharging debts incurred under state law in bankruptcy. Current exceptions to discharge include alimony and child support payments which are required and enforced by state law.[60] The choice here was a conscious one. Congress even opened the § 523(a)(19) exception up to state law securities law violations. Throughout the Code, particularly as most recently amended, there is a pervasive assumption that securities laws can adequately prevent and redress injuries to investors, the market, and

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56. Robert J. Bein, *Subjectivity, Good Faith and the Expanded Chapter 13 Discharge*, 70 MO. L. REV. 655, 666–67 (2005); Lucian Murley, *Closing a Bankruptcy Loop-Hole or Impairing a Debtor's Fresh Start? Sarbanes-Oxley Creates a New Exception to Discharge*, 92 KY. L.J. 317, 319–21 (2003).

57. *See* 11 U.S.C.A. § 707(b) (West Supp. 2006). BAPCPA "quite plainly reflects the Congressional preference for Chapter 13 over Chapter 7. Congress designed the 2005 Act to cause the majority of consumer debtors to proceed under Chapter 13, rather than Chapter 7." Bein, *supra* note 56, at 668.

58. Bein, *supra* note 56, at 678 (stating that "it is an abuse of the provisions of Chapter 13"); Murley, *supra* note 56, at 537–38.

59. According to U.S. Courts Bankruptcy Statistics for the calendar year ending December 31, 2005, the total number of Chapter 11 bankruptcy filings was 5,923. Bankruptcy Statistics, U.S. Bankruptcy Courts, *available at* http://www.uscourts.gov/bnkrpctystats/statistics.htm (last visited Apr. 1, 2007). In 2005, only 86 public companies filed Chapter 11 bankruptcy. Public-company Bankruptcies Falling '06, Boston Globe, Jan. 22, 2007, *available at* http://www.boston.com/business/ticker/2007/01/publiccompany_b.html (last visited Apr. 1, 2007).

60. 11 U.S.C.A. § 523(a)(15) (West Supp. 2006).

creditors at the hands of dishonest, disloyal corporate managers without reference to or cooperation from state law.

C. Chapter 11 Trustee

Perhaps the most clear, bankruptcy-specific remedy available to a debtor corporation in the face of severe mismanagement is the appointment of a chapter 11 trustee provided by section 1104 of the Code. Section 1104 does not specifically leave state law corporate governance standards behind, but rather incorporates them implicitly through its standard for "cause" to appoint a trustee.[61] Where cause exists, the appointment of a trustee is mandatory.[62] Because cause exists when managers have breached their fiduciary duties under state law,[63] any breach of fiduciary duty would result in the mandatory appointment of a trustee in some capacity. The latest addition to section 1104, subsection (e), in keeping with the current trend in corporate law, makes way for securities law violations without similarly giving credence to the goals and policies state law has developed. Subsection (e) requires the United States trustee ("UST") to move for the appointment of a chapter 11 trustee upon having "reasonable grounds to suspect" the debtor's current management has "participated in actual fraud, dishonesty, or criminal conduct in the management of the debtor or the debtor's public financial reporting."[64] While section 1104(e) does not specifically mention the securities laws, the suspicions that would give rise to the UST's mandatory motion unambiguously describe securities violations.[65] Whether or not a trustee would be or should be appointed under these circumstances is not important for the purposes of this essay. More important is that Congress's preference

61. Section 1104(a) of the Code provides:

> At any time after the commencement of the case but before confirmation of a plan, on request of a party in interest or the United States trustee, and after notice and a hearing, the court shall order the appointment of a trustee –
>
> (1) for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case, or similar cause, but not including the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor . . . .

11 U.S.C. § 1104(a) (2000).

62. "[T]he court *shall* order the appointment of a trustee. . . ." *Id.*

63. "Fraud" and "dishonesty" correspond to the fiduciary duty of loyalty, "incompetence" corresponds to the duty of care and "gross mismanagement" is a vague term that can apply to any breach of fiduciary duty.

64. 11 U.S.C.A. § 1104(e) (West Supp. 2006).

65. Levin & Ranney-Marinelli, *supra* note 38, at 618–19.

of the use of securities laws to govern corporate managers is exhibited once again in this addition to the Code.[66]

Section 1104 gives the Code's only account of what corporate governance standards apply to managers of a bankrupt corporation. While the management misdeeds enumerated in subsection (a) that give rise to the appointment of a trustee for cause track breaches of fiduciary duty under state law, a motion under subsection (a) is brought voluntarily by a party in interest or *sua sponte* by a court, usually in only the most egregious of circumstances.[67] The United States trustee is *required* to move under subsection (e), however, upon mere suspicion of securities violations by a debtor's current management.[68] This is a further indication of Congress's strong desire to insure that corporate managers cannot seek refuge from their responsibilities to the investing public in a bankruptcy case. In addition to continuing to face SEC or SRO investigation, fraudulent, dishonest, or criminal managers may lose some or all of the control they exercise over a debtor corporation. Securities enforcement actions and investigations will proceed after a bankruptcy filing and will be taken very seriously insofar as they signal something about the management team operating a fragile corporate debtor.

In contrast, within the context of chapter 11, a suit against directors and officers for breach of fiduciary duty is not likely to receive a hearing on the merits, let alone succeed. Derivative actions brought by shareholders on behalf of the debtor corporation are barred by the automatic stay because only the debtor in possession or trustee may exercise control over property of the debtor's estate.[69] Even if the debtor in possession or trustee pursues a cause of action alleging breach of fiduciary duty under state law, it may simply be settled or released in the debtor's plan of reorganization.[70] Further, if an officer or director who is the defendant in such a suit files an individual bankruptcy, the litigation will not only be stalled by that automatic stay, but any liability for breach of fiduciary duty to the corporation will be discharged. The state law action for breach of fiduciary duty simply does not have a

66. The practical application of section 1104(e) is not perfectly clear. The UST is required to move for the appointment of a trustee upon developing reasonable suspicion, but a court can only appoint a trustee under section 1104(a)(1) upon clear and convincing evidence. What is a UST without clear and convincing evidence to do? Should he bring a motion he knows will not be successful? *Id.*

67. *In re* Bibo, Inc., 76 F.3d 256, 258 (9th Cir. 1996); *In re* William A. Smith Constr., 77 B.R. 124, 126 (Bankr. N.D. Oh. Aug. 24, 1987).

68. § 1104(e).

69. Mitchell Excavators, Inc. v. Mitchell, 734 F.2d 129, 131 (2d Cir. 1984).

70. *See, e.g.* Agostino v. Hicks, 845 A.2d 1110, 1116–17 (Del. Ch. 2004); *In re* XO Communications, 330 B.R. 394 (Bankr. S.D.N.Y. Sep. 23, 2005).

reliable means of enforcement on its own terms in bankruptcy.[71] Breaches of fiduciary duty by a debtor's current management are best addressed by motions to appoint a chapter 11 trustee under 1104(a). While the specific state law enforcement mechanism loses its power in bankruptcy, a debtor corporation or its parties in interest should be able to hold accountable those corporate officers and directors who would be subject to liability under state law.

Section 1104 can only be as useful and broad in its scope as it is designed to be if bankruptcy courts use the discretion the section provides to fashion the remedy of a trustee to best fit the needs of the debtor before the court. As the law is applied now, a trustee usually replaces the troubled management entirely. Courts can use their discretion to appoint a trustee with more narrowly defined duties.[72] If the trustee is reserved as a necessarily drastic remedy useful only in the most egregious circumstances, when the complete ouster of the debtor's management from power is warranted, it cannot help debtor corporations heal from past harm or prevent future harm at the hands of disloyal or grossly incompetent leaders. The relative unimportance of the state common law of corporate governance in bankruptcy is supported by strong policy considerations. The imperfect fit between state law and the law governing a bankruptcy case by no means leaves a hopeless gap in the law governing the behavior of corporate managers.

IV. EFFECT ON CORPORATE GOVERNANCE IN BANKRUPTCY

Sarbanes-Oxley and the SEC and SRO regulations that accompany it represent the most recent steps federal law has taken into the realm of corporate governance. While the intrusions on what was once left solely to state corporate law are extensive, they do not render the state law of corporate governance obsolete.[73] Shareholder suits against corporate directors still dominate the law governing corporate acquisitions and are the primary, if not

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71. A derivative suit usually only survives in bankruptcy when a trustee has taken over for the debtor in possession or when the debtor in possession is being operated by new management.

72. *See In re* Northern American Commc'ns., Inc., 138 B.R. 175 (W.D. Pa. Mar. 19, 1992); *In re* La Sherene, Inc., 3 B.R. 169 (Bankr. N.D. Ga. Mar. 4, 1980). *But see* Commodity Futures Trading Commission v. Weintraub, 105 S. Ct. 1986, 1993 (1985) (deciding whether a chapter 11 trustee had authority to waive a corporation's attorney client privilege, the Supreme Court found that "Congress contemplated that when a trustee is appointed, he assumes control of the business, and the debtor's directors are 'completely ousted,'" so that a trustee may conduct an investigation of those directors unimpeded by any authority they may maintain).

73. Veasey, *supra* note 6, at 443.

only, means to redress breaches of the duty of loyalty.[74] While state law remains an important part of the corporate governance landscape for solvent companies, it has been rendered virtually irrelevant in the bankruptcy context in favor of federal securities laws. There are some advantages to this approach, but the benefits of placing such a premium on securities laws to ensure the accountability of corporate officers and directors are largely limited to publicly traded companies which constitute only a very small percentage of the corporate chapter 11 cases filed.[75] The resulting gap in the accountability of corporate managers in bankruptcy may leave the shareholders and creditors of a bankrupt corporation without redress for injury suffered at the hands of dishonest, disloyal, or grossly incompetent managers. For all that federal securities law reforms have done for public corporations, their ambitious policy goals do not even reach the large, and growing, number of corporations that are private. Bankruptcy law has the tools to close this gap, but they are not being used as effectively as they could be. If Congress will not account for managers' responsibility for driving a company to bankruptcy and injuring shareholders and creditors through their mistreatment of the now bankrupt corporation itself, then bankruptcy courts must step forward and creatively use the enforcement mechanisms provided them in order to do so.

Nearly twenty years before the Enron and WorldCom corporate disasters, the Delaware Supreme Court handed down its decision in *Smith v. Van Gorkom*[76] which sent shock waves around the corporate world.[77] The *Van Gorkom* decision imposed personal liability on directors for breaching their duty of care in negotiating the sale of their company.[78] The decision was unexpected and represented an unusual review of the merits of a business decision by the Delaware courts. The Delaware legislature responded promptly with the addition of section 102(b)(7) which allowed corporations to "opt out" of personal liability for directors for breaches of the duty of care.[79] As a result of that legislative answer to a movement in the direction of regulating what happens in the boardroom and what steps responsible directors must take in making business decisions, enforcement of the duty of care became virtually impossible under state law.[80] The failure of state corporate

74. *Id.*
75. *See supra* text accompanying note 59.
76. 488 A.2d 858 (Del. 1985).
77. Quillen, *supra* note 7, at 117–19.
78. *Id.*
79. DEL. CODE ANN. tit. 8, § 102(b)(7) (2006).
80. Thompson & Sale, *supra* note 4, at 904–08. Because of a jurisdictional gap in Delaware law, it can be very difficult to sue officers for breach of duty of care although they are directly responsible for such breaches that cause significant harm to the corporation. Sarbanes-Oxley provisions specifically

law to address mismanagement committed by officers is blamed in part for the corporate scandals of the early 2000s. Congress saw an opportunity to act, to step into the law of corporate governance in a significant way for the first time, and Sarbanes-Oxley was born.[81]

With the goals of Sarbanes-Oxley still in mind and the urge to do even more to prevent another Enron and to insure that those responsible for such behavior are held completely accountable for their actions, Congress sought to insure the success of federal corporate governance law in bankruptcy. The result was the addition of subsections 362(b)(25) and 1104(e) to the provision Sarbanes-Oxley had already added, 523(a)(19). In some ways, the supremacy of the federal law of corporate governance in bankruptcy makes sense. Federal securities laws offer a more precise set of rules against which to measure management conduct.[82] Federal procedures can also be more straightforward and efficient than state law counterparts.[83] This all makes federal securities laws easier to enforce and more predictable in their application. Ease and efficiency of enforcement is crucial to a corporation in bankruptcy, with necessarily limited resources. It is important to all of a bankrupt corporation's parties in interest that the corporation and its officers and directors understand exactly what their responsibilities are and were and exactly what actions they may be held accountable for within the bankruptcy case and what the attendant punishments or remedies will be. State fiduciary law is driven by intentionally imprecise standards applied in equity. The result of that lack of predictability could be to make the enforcement of fiduciary duties too expensive for a corporate debtor and its parties in interest to bother with.[84] While enforcing securities laws and regulations, the SEC and SROs may cause much less disruption to a corporate debtor than state law litigation would. Most importantly, because the SEC and SROs can pursue meaningful non-monetary sanctions against wrongdoers, they offer an alternative means for corporate accountability that does not threaten a debtor's bottom line.

The curious exception to these advantages is 523(a)(19). Because individual debtors cannot discharge debts resulting from settlements or

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refer to officers, claiming that they are really the ones running the show. Justice Veasey argues that directors are supposed to be "in charge" under Delaware law and should be held responsible for failing to supervise officers. Veasey, *supra* note 6, at 445–46. That failure would constitute a breach of the duty of care for which directors cannot be held personally liable. Here we have a circular problem.

81. Cunningham, *supra* note 2, at 917, 954–55.

82. Johnson & Sides, *supra* note 3, at 917, 954–55.

83. Joel Seligman, *The New Corporate Law*, 59 BROOK. L. REV. 1, 29–31 (1993).

84. If a suit for breach of fiduciary duty against a director would cost more to pursue than the estate would realize, it is released in bankruptcy.

judgments imposed by the violation of securities laws, those suits may proceed and their effects may be felt despite an individual or corporate bankruptcy. This leaves a hole through which shareholder securities class actions can run to exact monetary penalties against individual corporate managers.[85] It is not clear what advantage these actions have over suits for breach of fiduciary duty under state law. If one kind of recovery can be excepted from discharge, it is difficult to see why the other is not.

This is particularly curious in light of the fact that the Sarbanes-Oxley reforms are not as significant or far-reaching as they were marketed as being.[86] For one thing, Sarbanes-Oxley chiefly regulates accounting practices, which, while representing an important kind of potential managerial lapse, are far from being the only means by which rogue corporate managers can harm investors or the corporation for whom they work. Provisions that seek to address particular kinds of misconduct that sound in state fiduciary law, such as the ban on corporate loans to insiders[87] and the requirement that CEOs and CFOs personally approve financial disclosures,[88] again reach only very particular circumstances and do not create a complete or consistent framework within which corporate governance can be organized and monitored. State law fills these gaps by providing broader standards against which to measure managerial, particularly director, conduct, but the remedy for breach of fiduciary duty, personal liability for the offending director, is so extreme that courts are very hesitant to apply it. Delaware law has shied further and further away from imposing personal liability on directors, reserving that penalty for only the most extreme instances of misconduct.[89] Because the remedy available under state law is one courts are hesitant to impose, the problem with the enforcement of state corporate governance law may be the remedy itself. That is one point on which bankruptcy law may have an advantage. Bankruptcy law has devised its own remedy to respond to situations in which the current managers of a corporation are guilty of severe mismanagement. The appointment of a chapter 11 trustee allows a bankrupt company to relieve itself of poor or disloyal management without undergoing the long, uncertain process of trying to impose liability under state law standards.

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85. These suits exact a penalty because they do not result in compensatory recovery for shareholders. Individual shareholders receive very little from a successful suit. The plaintiffs' attorneys are the real beneficiaries. Thompson & Sale, *supra* note 4, at 904.
86. Cunningham, *supra* note 2, at 917–18.
87. *Id.* at 959–60.
88. *Id.*
89. Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules & the Derivative Suit in Corporate Law: A Theoretical & Empirical Analysis*, 71 CORNELL L. REV. 261, 266 (1986).

The trustee remedy may be able to make the most of a combination of federal and state standards for management conduct. A violation of federal securities laws and regulations by a debtor's current management may constitute cause to appoint a trustee or may lead a court to find that the best interests of a debtor require the enhanced supervision a trustee can provide. The precise nature of federal laws on this subject may make it easier for a court to determine when it should appoint a trustee. Section 1104 also constitutes a portal through which state law standards can become relevant within a bankruptcy case. A breach of fiduciary duty under state law would also constitute cause to appoint a trustee. This is a way for bankruptcy courts to hold the debtor's current management to their obligations under state law without forcing the debtor to seek the cumbersome and narrow state law remedy. Further, because 1104(e) does not specifically mention federal securities laws, a US Trustee must move for the appointment of a trustee if he reasonably suspects that current management has engaged in fraud or dishonesty in its operation of the debtor corporation, whether the corporation is publicly traded or not. While non-public corporations will not have public financial reporting obligations, their officers and directors can be held accountable for fraudulent or dishonest management, through removal from power over the corporation or closer supervision for the debtor's protection, at the first signal of their wrongdoing.

Granted, the trustee remedy, as it is used now, would be an extremely ineffective way to address all but the most egregious management situations. Further, if a debtor's managers are so harmful to the corporation that they have to be removed, creditors have most likely removed them already.[90] In order for the trustee remedy to be an effective, efficient remedy in its own right, courts must use the discretion afforded them to apply it in a more limited, flexible manner. A trustee need not displace the debtor's management entirely when its behavior is not so bad as to warrant that extreme of an intrusion. Rather, a bankruptcy court should tailor the use of the trustee to a particular debtor's circumstances and needs.

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90. *See* A. Mechele Dickerson, *The Many Faces of Chapter 11: A Reply to Professor Baird*, 12 AM. BANKR. INST. L. REV. 109, 128–29 (2004) (stating that creditors have the right "to quickly remove incompetent managers"). *But see* Stuart C. Gilson & Michael R. Vetsuypens, *Creditor Control in Financially Distressed Firms: Empirical Evidence*, 72 WASH. U. L. Q. 1005, 1012–13 (1994) (explaining that, during an empirical study, creditors in 75% of insolvent companies threatened to remove managers, but only in one case was a manager actually removed).

V. CONCLUSION

Because the Sarbanes-Oxley reforms are not as broad as they seem, federal law cannot be the only standard for corporate governance in bankruptcy. State law policies, if not remedies, should be remembered and respected in determining how to address disloyal or severely incompetent managers. Congress did not preserve state law duties in any specific way in amending the Bankruptcy Code and was remiss in focusing so singularly on federal securities regulations which only address a very small portion of potential problems with the management of bankrupt corporations. Through their interpretation of the Code and the use of the discretion Congress has left them, bankruptcy courts must fill the existing gap to protect corporate debtors and their parties in interest by taking every opportunity they have to hold the directors and officers of bankrupt corporations to the standards of behavior imposed by both state and federal law. By doing so, bankruptcy courts can preserve the benefits and flexibility of state law standards while still holding rogue directors and officers accountable for their violation of clear federal rules.